

Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 CIAE-00 DODE-00 PM-04 H-01 INR-07 L-03
NSAE-00 NSC-05 PA-01 PRS-01 SP-02 SS-15 AID-05 EB-08
CIEP-01 TRSE-00 STR-04 OMB-01 CEA-01 COME-00 FRB-03
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INRE-00 /085 W

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FM AMEMBASSY OTTAWA
TO SECSTATE WASHDC IMMEDIATE 2415
INFO AMCONSUL MONTREAL
USMISSION OECD PARIS
ALL OTHER AMCONSULS CANADA

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STATE FOR COOPER AND HARTMAN; TREASURY FOR SOLOMON AND
BERGSTEN; CEA FOR SCHULTZE

E.O. 11652: N/A
TAGS: EFIN, CA
SUBJ: CANADIAN EXTERNAL DEBT AND BALANCE OF PAYMENTS

1. SUMMARY: FOREIGN BORROWING BY CANADA HAS RISEN
RAPIDLY IN THE PAST TWO YEARS. NET NEW FOREIGN BON
ISSUES ROSE FROM \$550 MILLION IN 1973 TO NEARLY \$8 BILLION
LAST YEAR, AND THE LEVEL OF NET PORTFOLIO LIABILITY
AT THE END OF 1976 WAS PROBABLY IN EXCESS OF \$30 BILLION.
NET INTEREST AND DIVIDEND PAYMENTS ABROAD WILL PROBABLY
BE OVER \$3 BILLION IN 1977, RAISING QUESTIONS ABOUT CANADA'S
CURRENT ACCOUNT POSITION. EMBASSY'S ANALYSIS INDICATES,
HOWEVER, THAT THE RATE OF FOREIGN BORROWING WILL MODERATE
CONSIDERABLY THIS YEAR AND NEXT. WE EXPECT CANADA'S
CURRENT ACCOUNT WILL SHOW CONTINUED IMPROVEMENT, BASED ON
A WIDENING TRADE SURPLUS. RISKS REMAIN THAT CANADA'S
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CURRENT ACCOUNT DEFICIT COULD WIDEN IF U.S. ECONOMIC
GROWTH RATES FALTER FROM THEIR CURRENTLY ANTICIPATED
LEVELS OF AROUND FIVE PERCENT. END SUMMARY.

2. EMBASSY ESTIMATES OF CANADA'S CURRENT AND CAPITAL
ACCOUNT BALANCE ARE BASED ON ANALYSIS OF DATA FROM
OFFICIAL AND PRIVATE CANADIAN SOURCES, INCLUDING

STATISTICS CANADA, THE BANK OF CANADA, THE UNIVERSITY OF TORONTO, AND INVESTMENT FIRMS.

3. FOREIGN DEBT. SINCE 1975 MONETARY POLICY HAS BEEN SET BY THE BANK OF CANADA ON A M1 GROWTH TARGET RATHER THAN AN INTEREST RATE OR EXCHANGE RATE. TIGHT MONEY TO RESTRAIN M1 GROWTH OPENED UP WIDE INTEREST RATE DIFFERENTIALS WITH THE U.S. IN 1975 AND REACHED A PEAK IN THE SPRING OF 1976, LEADING O MASSIVE CAPITAL INFLOWS AND RAPIDLY RISING LEVELS OF FOREIGN DEBT. STATISTICS CANADA ESTIMATES THAT THE LEVEL OF NET FOREIGN INDEBTEDNESS (INCLUDING RETAINED EARNINGS ON DIRECT INVESTMENT AND CANADA'S IMF POSITION) WAS \$43.3 BILLION AT THE END OF 1975. OF THIS, THE EMBASSY'S ESTIMATES OF CANADA'S NET FOREIGN PORTFOLIO LIABILITY ARE:

1975: 24.3 BILLION

1976: 32.3 BILLION

1977: 36.8 BILLION

1978: 41.5 BILLION

4. MOST OF THE INCREASED DEBT HAS COME FROM FOREIGN BORROWING BY PROVINCES AND UTILITIES UNDER PROVINCIAL GUARANTEES. NET NEW FOREIGN BOND ISSUES (INCLUDING RETIREMENTS) ROSE FROM \$550 MILLION IN 1973 TO \$4.5 BILLION IN 1975. FOREIGN BORROWING IS EXPECTED TO LIMITED OFFICIAL USE

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TAPER OFF IN THE NEXT TWO YEARS. ESTIMATES MADE IN JANUARY 1977 BY WOOD GUNDY, LIMITED (TORONTO) OF NET NEW FOREIGN BOND ISSUES ARE:

1976: 7.9 BILLION

1977: 4.6 BILLION

1978: 4.9 BILLION

5. THESE ESTIMATES REFLECT NO ACCELERATION OF THE EXPENDITURES OR BORROWING REQUIREMENTS BY HYDRO QUEBEC ON THE JAMES BAY PROJECT IN 1978, WHICH HAD BEEN FORESEEN BY WOOD GUNDY LAST YEAR. CONTINUED CONSTRUCTION BY HYDRO QUEBEC IS EXPECTED AT CURRENT RATES AND CONTINUED ACCESS BY IT TO FOREIGN CAPITAL MARKETS IN LATE 1977 AND 1978.

6. BALANCE OF PAYMENTS: CURRENT ACCOUNT. CANADA'S MERCHANDISE TRADE BALANCE IS HEAVILY INFLUENCED BY RATES OF ECONOMIC ACTIVITY IN THE U.S. THE BANK OF CANADA ESTIMATES THAT OVER A BUSINESS CYCLE A ONE PERCENT CHANGE

IN REAL U.S. GNP WILL GENERATE A 1.5 PERCENT CHANGE IN
THE VOLUME OF CANADIAN EXPORTS, GIVING A DIRECT IMPACT
ON CANADIAN REAL GNP OF ABOUT ONE QUARTER OF ONE PERCENT.
THIS EFFECT IS MUCH STRONGER AT TURNING POINTS IN THE
CYCLE WHEN THERE ARE MAJOR NET CHANGES IN U.S.
INVENTORIES OF INDUSTRIAL MATERIALS AND WEAKER DURING
PERIODS OF STEADY GROWTH AS ANTICIPATED FOR THE U.S.
OVER THE NEXT TWO YEARS.

7. GROWTH IN CANADIAN IMPORTS IN 1977 IS EXPECTED
TO BE RELATIVELY SLOW. THE SLUGGISH STATE OF THE
ECONOMY IS EXPECTED TO KEEP DOWN THE GROWTH OF IMPORT
INTENSIVE SECTORS SUCH AS CONSUMER DURABLES, MACHINERY
AND EQUIPMENT. DEMAND FOR CONSUMER DURABLES IS ALSO
QUITE PRICE SENSITIVE; THE RECENT WEAKNESS OF THE
CANADIAN DOLLAR IS THUS A FURTHER FACTOR RESTRAINING
IMPORT GROWTH IN THIS AREA.
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8. THE CURRENT ACCOUNT BALANCE SHOWN BELOW IS BASED ON

FORECASTS OF U.S. REAL GNP GROWTH OF AROUND FIVE PERCENT THIS YEAR, LITTLE MODERATION OF THAT RATE IN 1978, AND CANADIAN GROWTH RATES LAGGING THE U.S. OVER THE SAME TIME PERIOD. THE CANADIAN FISCAL POLICY STANCE IS ASSUMED TO SHOW LITTLE CHANGE, WITH THE SPRING BUDGET INTRODUCING ONLY SELECTIVE MEASURES TO STIMULATE INVESTMENT AND DEAL WITH REGIONAL AND SECTORAL UNEMPLOYMENT PROBLEMS TO A DEGREE SUFFICIENT TO KEEP OVERALL FISCAL POLICY FROM BECOMING MORE RESTRICTIVE. (FINANCE MINISTER MACDONALD HAS NOTED THAT UNDER EXISTING PROGRAMS AGGREGATE GOVERNMENT SPENDING -- FEDERAL, PROVINCIAL AND MUNICIPAL -- WOULD SHOW A SMALLER DEFICIT IN 1977 THAN LAST YEAR, A POLICY STANCE WHICH HE HINTED SEEMED OVERLY SEVERE GIVEN THE EXPECTED RISING RATE OF UNEMPLOYMENT.) ALL FIGURES ARE IN BILLIONS OF CURRENT CANADIAN DOLLARS.

	1975A	1976E	1977F	1978F
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MERCHANTISE

TRADE	0.6)	1.1	2.3	2.9
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SERVICES	(4.7)	(5.5)	(6.1)	(6.5)
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OF WHICH:

- TRAVEL	(0.7)	(1.2)	(1.0)	(1.0)
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- INTERESTS AND

DIVIDENDS	(2.0)	(2.5)	(3.2)	(3.6)
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NET TRANSFERS	.4	.4	.4	.3
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CURRENT BALANCE	(4.9)	(4.0)	(3.4)	(3.3)
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9. THE QUARTERLY ECONOMETRIC MODEL OF THE UNIVERSITY OF TORONTO HAS ESTIMATED THAT A THREE PERCENT CUT IN PERSONAL INCOME TAXES AT MID-YEAR COULD REDUCE UNEMPLOYMENT IN THE SECOND HALF OF THE YEAR BY AS MUCH AS ONE HALF OF ONE PERCENTAGE POINT, ALTHOUGH THE EFFECT MIGHT BE QUITE LIMITED ON GNP GROWTH AS INVENTORIES WERE DRAWN DOWN AND IMPORTS INCREASED. SUCH ADDITIONAL STIMULUS WOULD ADD ABOUT \$100 MILLION TO THE IMPORT BILL FOR THE YEAR.

10. TO ACHIEVE A GROWTH RATE AS HIGH AS FIVE PERCENT, VERY ROUGH CALCULATIONS INDICATE THAT GOVERNMENT PROGRAMS WOULD NEED TO BE PUT IN PLACE WHICH WOULD ENLARGE THE GOVERNMENT SECTOR DEFICIT BY NEARLY AN ADDITIONAL \$2 BILLION, INCREASING THE CURRENT ACCOUNT DEFICIT BY PERHAPS \$500-600 MILLION.

11. BALANCE OF PAYMENTS: CAPITAL ACCOUNT. WHILE THE

LEVEL O FOREIGN BORROWING IS EXPECTED TO DROP DURING THE NEXT TWO YEARS BELOW LAST YEAR'S HIGH, IT WILL PROBABLY CONTINUE AT HISTORICALLY HIGH LEVELS. THE HEAVIEST BORROWERS WILL CONTINUE TO BE THE PROVINCES, IN LARGE PART TO MEET THE HEAVY CAPITAL REQUIREMENTS OF THEIR UTILITIES. RATES OF FOREIGN BORROWING THIS YEAR LIMITED OFFICIAL USE

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WILL BE INFLUENCED BY INTEREST RATE DIFFERENTIALS, SLUGGISH RECOVERY EXPECTED IN CANADA, POLITICAL CONDITIONS IN QUEBEC, A DEGREE OF BORROWING LAST YEAR IN ANTICIPATION OF FUTURE NEEDS, AND POSSIBLY SOME QUIET JAWBONING BY FEDERAL AUTHORITIES TO ENCOURAGING COMESTIC RATHER THAN FOREIGN BORRWOING.

12. THE RATE OF FOREIGN BORROWING IS NOT WITHOUT SOME POLITICAL SENSITIVITY. FOR ONE, THE FEDERAL GOVERNMENT DOES NOT WANT TO APPEAR TO BE INTERFERING DIRECTLY WITH PROVINCIAL PREROGATIVES TO DO THEIR FINANCING WHERE THEY JUDGE BEST. FOR ANOTHER, QUEBEC PROVINCIAL BORROWERS IN THE PAST HAVE CLAIMED TO FIND MORE SYMPATHY IN NEW YORK THAN IN TORONTO. THIS MAY EXPLAIN WHY THE HIGH RATE OF FOREIGN BORROWING IS SELDOM DISCUSSED PUBLICLY BY FEDERAL MINISTERS.

13. THE CAPITAL ACCOUNT BALANCE FOR 1975-77 SHOWN BELOW, IN BILLIONS OF CURRENT CANADIAN DOLLARS, IS BASED ON WORK BY THE UNIVERSITY OF TORONTO AS MODIFIED BY THE EMBASSY:

	1975A	1976E	1977F	1978F
DIRECT INVESTMENT (NEG)	(0.9)	(0.6)	(0.5)	
NEW BOND ISSUES	4.5	7.9	4.6	4.9
OTHER PORTFOLIO	.2	.1	(0.3)	(0.2)
OTHER LONG TERM CAPITAL	(0.6)	(0.6)	(0.6)	(0.8)
SHORT TERM CAPITAL AND BALANCING ITEM	.4	(2.0)	.3	(0.1)

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CAPITAL ACCOUNT

BALANCE	4.5	4.5	3.4	3.3
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CHANGE IN

RESERVES	(0.4)	0.5	--	--
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14. COMMENT: SLOWER GROWTH IN THE CANADIAN ECONOMY THAN IN THE U.S. IN 1976 PRODUCED A TURNAROUND IN CANADA'S MERCHANDISE TRADE BALANCE OF MORE THAN \$1.75 BILLION, WHICH MORE THAN OFFSETT THE INCREASED OUTFLOW IN THE CURRENT ACCOUNT FOR SERVICING THE GROWING FOREIGN DEBT. THE SAME CONDITIONS OF SLOWER GROWTH IN CANADA THAN THE U.S. ARE NOW EXPECTED TO PREVAIL OVER THENEXT TWO YEARS, PROGRESSIVELY REDUCING THE CURRENT ACCOUNT DEFICIT. HOWEVER, RISKS EXIST THAT AN UNEXPECTED SLOWDOWN IN THE U.S., ESPECIALLY ANY MAJOR DECUMULATIONOF INVENTORIES OF INDUSTRAIL MATERIALS, COULD CHANGE THIS PICTURE CONSIDERABLY FOR THE WORSE.
ENDERS

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Message Attributes

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